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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

The 1978 Navy Shipbuilding Claim Settlement At Electric Boat-- Status As Of July 2, 1983

The 1979 Defense Appropriation Authorization Act authorizes the Comptroller General to review two contracts with General Dynamics Corporation, Electric Boat Division, for building 18 SSN-688 class nuclear attack submarines. These contracts were involved in a shipbuilding claim settlement.

The review is to insure that funds authorized to pay for contract modifications made in the interest of national defense are used only on the two contracts, and that the contractor does not use such funds to realize any total combined profit on these contracts. This is GAO's fifth report on these contracts.

On the basis of information available at the time of this review, GAO concluded that the funds authorized for the settlement are being used on the specified contracts and that the contractor is still projecting a loss on these contracts.



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MAY 18, 1984

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COMPTROLLER GENERAL OF THE UNITED STATES

WASHINGTON D.C. 20548

B-197665

To the President of the Senate and the
Speaker of the House of Representatives

This is our fifth report on the status of two SSN-688 class attack submarine contracts (N00024-71-C-0268 and N00024-74-C-0206) that were awarded to General Dynamics Corporation and that were modified in 1978 under the authority of Public Law 85-804. This report covers the period from December 27, 1981, through the corporation's second quarter accounting period ending July 2, 1983. Our first four reports (PSAD-79-107, Oct. 2, 1979; PSAD-80-68, Aug. 18, 1980; PLRD-82-2, Oct. 20, 1981; and PLRD-83-5, Oct. 26, 1982) covered the period from June 9, 1978 (date of settlement) to December 26, 1981.

In June 1978, after years of disagreement over \$544 million of shipbuilding claims filed by General Dynamics Corporation's Electric Boat Division relating to construction of nuclear attack submarines, the Navy and the contractor agreed to a settlement based on an estimated cost at completion of \$2,672 million, which included \$3.9 million for change orders in process. The agreement was reached under Public Law 85-804, which allows the President to modify contracts without regard to certain other laws in the interest of national defense.

The settlement provided that an estimated loss of \$843 million over the remaining life of the contracts would be covered as follows: (1) the contract price would be increased by \$125 million to cover existing claims against the Navy, (2) the contractor would absorb a \$359 million loss over the remaining submarine construction period, and (3) the Navy would pay another \$359 million under the authority of Public Law 85-804. Cost overruns beyond the estimated cost at completion of \$2,672 million would be divided equally up to a total of \$100 million with costs above that figure being the total responsibility of General Dynamics, and cost underruns would be shared equally.

Section 821 of the 1979 Defense Appropriation Authorization Act (Public Law 95-485) authorizes the Comptroller General to perform reviews and report to the Congress on the status of the contracts. These reviews are to insure that funds authorized to provide relief under Public Law 85-804 in the 1978 claims settlement are used only on the two contracts and that General Dynamics, the prime contractor, does not use such funds to realize any total combined profit on the contracts.

We conducted our review at the Electric Boat Division of General Dynamics Corporation and at the offices of the Supervisor of Shipbuilding, Conversion and Repair, U.S. Navy in

Groton, Connecticut. We reviewed Electric Boat and Navy cost and payment records and documents pertaining to the two contracts for the period December 27, 1981, through July 2, 1983. We did not, however, assess the reliability of computer-generated data provided by the contractor from its contractually required cost reporting system.

Our October 2, 1979, report entitled Two Contracts for Nuclear Attack Submarines Modified by Public Law 85-804--Status as of December 23, 1978 (PSAD-79-107) did, however, assess the results of the Defense Contract Audit Agency's (DCAA's) operations audits which evaluate the adequacy of Electric Boat's management control systems and the reliability of the contractor's cost accounting records. We concluded that DCAA's work was properly planned and performed and that its conclusions were valid. On the basis of this review, we believe that DCAA's monitoring of contractor operations and of costs incurred is sufficient to provide assurance that costs charged to the SSN-688 contracts are correct, and that the contractor is complying with the terms of the settlement. Our subsequent work did not disclose anything that would change our opinion.

We also reviewed DCAA's audit of Electric Boat's progress payment requests for the -0206 contract for the year ended December 31, 1982. DCAA stopped reviewing payments under contract -0268 in 1982 because it is essentially complete. DCAA audits the progress payments to ensure that the contractor is following the billing procedures agreed to in the 1978 claims settlement and that Electric Boat's share of the loss is being absorbed through reductions in progress payments. Our review was made in accordance with generally accepted government auditing standards.

As of July 2, 1983, we found that:

- Funds provided under the Public Law 85-804 settlement were being used only on the specified contracts.
- Electric Boat Division continued to project an overall loss and General Dynamics had written off losses on these contracts since the Public Law 85-804 settlement in June 1978 amounting to \$487 million. (See table 2.)
- Electric Boat had delivered 14 of the required 18 submarines under these contracts. (See updated data on p. 5.)

Electric Boat has overrun the contracts' ceiling prices by more than \$100 million and presently is absorbing 100 percent of any cost overrun. Also, the contractor has absorbed, through reduced progress payments, \$341.5 million, or 95 percent, of the \$359 million loss required by the 1978 settlement. (See table 1.) Even with the losses on these two contracts, overall

submarine construction at Electric Boat is profitable for General Dynamics.

The following sections discuss the use of authorized funds, the combined profit/loss calculation, and other matters in more detail.

USE OF AUTHORIZED FUNDS

Through July 2, 1983, Electric Boat had incurred \$166 million of costs in excess of the absorbed loss and amounts billed the government. (See table 1.) The incurred costs included \$72.6 million questioned by DCAA as potentially unallowable under the cost principles of the Defense Acquisition Regulation. If the \$72.6 million is disallowed, unreimbursed allowable costs would still total \$93.4 million. The amounts expended by Electric Boat under the two contracts are considerably in excess of the reimbursements received. On this basis, we conclude that the funds authorized for the Public Law 85-804 settlement are being used on the specified contracts.

Table 1

	Contract ^a		
	<u>-0268</u>	<u>-0206</u>	<u>Total</u>
	(millions)		
Incurring costs	\$1,061.9	\$1,829.1	\$2,891.0
Less: Progress payments billed	-887.5	-1,397.1	-2,284.6
Extraordinary escalation billed or authorized ^b	<u>-6.9</u>	<u>-91.9</u>	<u>-98.8</u>
Unreimbursed costs	167.4	340.1	507.5
Less: Absorbed loss ^c	<u>-136.0</u>	<u>-205.5</u>	<u>-341.5</u>
Unreimbursed costs after absorbed loss	<u>\$ 31.4</u>	<u>\$ 134.6</u>	<u>\$ 166.0</u>

^aFigures may not total due to rounding.

^bExtraordinary escalation is additional costs attributable solely to inflation above that included in the \$2,672 million estimated cost at completion at the time of the 1978 settlement.

^cSettlement provides that the contractor will absorb an estimated loss of \$359 million over the remaining construction period.

During our review we learned that a federal grand jury, in September 1983, had indicted two former General Dynamics' officials for receiving kickbacks from a subcontractor in connection with shipbuilding contracts at the Quincy and Electric Boat shipyards. The bulk of the allegations in the indictment involve kickbacks on subcontracts on liquid natural gas tankers being built at Quincy, but there are allegations that subcontracts under SSN-688 class submarine contracts may also have been involved. The Navy is conducting an investigation to

determine what effect, if any, there was on the submarine contracts. The possible relationship between the alleged kick-backs and Public Law 85-804 settlement funds cannot be determined at this time.

COMBINED PROFIT/LOSS POSITION

Electric Boat is not realizing any total combined profit on the specified contracts. The estimated loss at completion at the time of the 1978 settlement had increased by \$178 million, to \$487 million as of July 2, 1983. The increase is due to a large overrun on the contracts.

Of the \$178 million cost overrun, the contractor and the government will share equally the first \$100 million according to the settlement cost sharing provisions. Thus, Electric Boat will absorb \$128 million of the projected cost overrun. As of the above date, Electric Boat had incurred all but \$130 million of the estimated \$3,021 million cost at completion.

The following table shows the details of our calculation of the contractor's estimated loss.

Table 2

	<u>Contract</u>		
	<u>-0268</u>	<u>-0206</u>	<u>Total</u>
	<u>----- (millions) -----</u>		
Estimated cost at completion on July 2, 1983	\$1,066	\$1,955	\$3,021
Less: Contract modifications at ceiling price ^a	-17	-44	-61
Extraordinary escalation forecast ^a	-7	-103	-110
Estimated cost for sharing purposes	1,042	1,808	2,850
Estimated cost at completion at time of 1978 settlement ^b	<u>-1,011</u>	<u>-1,661</u>	<u>-2,672</u>
Cost overrun before sharing	<u>\$ 31</u>	<u>\$ 147</u>	<u>\$ 178</u>
Navy sharing of overrun—50% up to \$100 million	<u>\$ 16</u>	<u>\$ 34</u>	<u>\$ 50</u>
100% of overrun to be absorbed by contractor	\$ 15	\$ 113	\$ 128
Estimated loss at completion of 1978 settlement to be absorbed by contractor	<u>136</u>	<u>223</u>	<u>359</u>
Estimated loss at completion as of July 2, 1983	<u>\$ 151</u>	<u>\$ 336</u>	<u>\$ 487</u>

^aTo determine the estimated cost at completion for sharing purposes, the estimate was reduced by the costs for contract modifications at ceiling price and extraordinary escalation forecast from January 1978 to the estimated completion dates of the two contracts. This reduction was made to convert total estimated cost to a basis consistent with the estimated cost at completion prepared at the time of the settlement.

^bThe \$2,672 million estimated cost at completion at the time of the settlement includes \$3.9 million ceiling price of contract modifications in process and adjudicated as part of the settlement.

CONSTRUCTION COSTS EXCEED
CONTRACT CEILING

Last year we reported that Electric Boat was nearing the contract ceiling beyond which it alone would absorb all costs. In 1983, construction costs to complete the two contracts exceeded the contract ceiling for government sharing, and Electric Boat is now absorbing 100 percent of the cost overrun.

DELIVERY DATES UNCHANGED
SINCE LAST REPORT

As of March 1, 1984, Electric Boat had delivered all 7 ships under contract -0268 and 9 of the 11 ships under -0206 to the Navy. A comparison of the 1978 negotiated delivery dates with the most recent contract modification delivery dates is provided in appendix II.

ELECTRIC BOAT AND DEPARTMENT
OF DEFENSE COMMENTS

As in comments on our previous report (GAO/PLRD-83-5, Oct. 16, 1982), Electric Boat again suggested (see app. III) that congressional concurrence be requested for the discontinuance of future GAO reviews of these contracts, since there is no possibility that it will realize any profit on these contracts. As we stated in our prior report, as long as the possibility exists that unexpected large claims or change orders could alter the loss situation, we believe it advisable to continue our audits.

Electric Boat further believes that the statement on the alleged kickback scheme at the shipyard is not germane to the clearly stated requirement and purpose of our report and that it should be deleted. It stated that based on its loss situation on the two contracts, the alleged kickback scheme could have no possible impact on the use of Public Law 85-804 settlement funds.

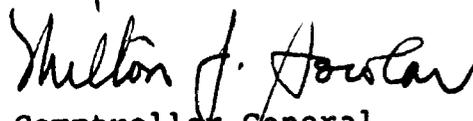
We have not deleted that statement because one of the requirements of our audit--as stated in the 1979 Defense Appropriation Authorization Act--is to insure that the Public Law 85-804 settlement funds are used only in connection with the specified contracts. This requirement pertains to whether the appropriated funds are being applied as the Congress intended. In this regard, any diversion of such funds for noncontractual purposes is germane to this requirement. The statement concerning the indictment is justified because of the alleged involvement of the SSN-688 contracts.

The Department of Defense agreed with the report facts and conclusions. (See app. IV.) For the purpose of completeness, it suggested several changes to our statement on the alleged

kickback scheme. These changes have been incorporated in the report.

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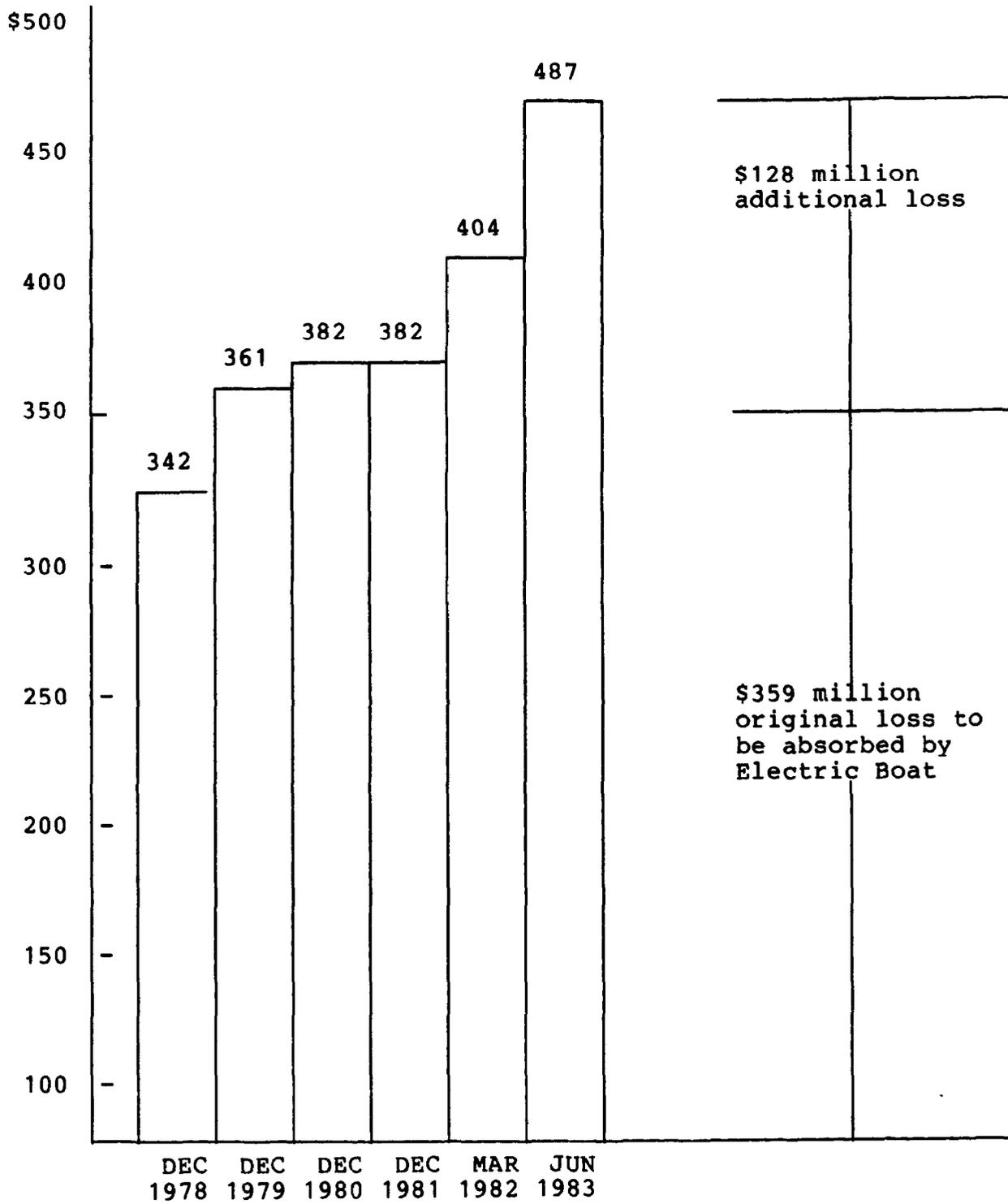
We are sending copies of this report to the Chairmen, Senate and House Committees on Armed Services; Senator William Proxmire; and the Chairman, General Dynamics Corporation.



Acting Comptroller General
of the United States

ELECTRIC BOAT'S ESTIMATED LOSS AT
COMPLETION ON PUBLIC LAW 85-804 CONTRACTS

Millions



COMPARISON OF DELIVERY DATES NEGOTIATED
UNDER THE 1978 SETTLEMENT WITH CURRENT DELIVERY DATES
FOR SSN 688s UNDER CONTRACTS -0268 AND -0206

<u>Contract and hull number</u>	<u>Delivery dates</u>	
	<u>1978 settlement</u>	<u>Current</u>
-0268:		
SSN 690	6-10-77	6-10-77 ^a
692	3-10-78	3-10-78 ^a
694	6-09-78	6-09-78 ^a
696	3-31-79	1-23-79 ^a
697	9-08-79 ^b	11-30-79 ^a
698	10-27-79	2-13-81 ^a
699	2-23-80	3-31-81 ^a
-0206:		
SSN 700	6-21-80	6-26-81 ^a
701	10-18-80	9-30-81 ^a
702	2-14-81	12-18-81 ^a
703	6-13-81	12-22-81 ^a
704	2-06-82	7-19-82 ^a
705	6-05-82	11-24-82 ^a
706	10-02-82	4-14-83 ^a
707	1-29-83	8-27-83 ^a
708	9-24-83	2-17-84 ^a
709	1-21-84	9-08-84 ^c
710	5-19-84	2-16-85 ^c

^aActual.

^bRevision to settlement date per contract modification.

^cContractual delivery dates agreed to on February 19, 1982.

GENERAL DYNAMICS***Electric Boat Division***

Eastern Point Road, Groton, Connecticut 06340 • 203 448-5960

January 30, 1984

Subject: General Accounting Office (GAO) Draft Report on "The 1978 Navy Shipbuilding Claim Settlement at Electric Boat -- Status as of July 2, 1983".

Reference: (a) United States General Accounting Office Letter (Mr. Frank C. Conahan) to Electric Boat Division (Mr. A. M. Barton), dated January 10, 1984, Same Subject.

Mr. Frank C. Conahan, Director
National Security and International Affairs Div.
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Conahan:

1. Electric Boat Division has received and reviewed the draft GAO audit report entitled "The 1978 Navy Shipbuilding Claim Settlement at Electric Boat - Status as of July 2, 1983". As requested in Reference (a), Electric Boat Division comments are provided in the following paragraphs.

2. GENERAL COMMENTS

As stated in your report, this is the fifth report on the status of two contracts for constructing SSN688 class attack submarines at Electric Boat modified in 1978 under the authority of Public Law 85-804. The purpose of each of the five reports has been the same, that is to ensure that (1) funds authorized for payment under Public Law 85-804 contract modification are being used only on the two contracts and (2) that Electric Boat will not use such funds to realize any total combined profit on these contracts. Each year the conclusion has also been the same, namely that (1) the funds are being spent as intended, and (2) construction costs have overrun the contract ceiling and the contractor is now bearing the entire cost of any overrun to complete deliveries. Since there is no possibility that Electric Boat will realize any profit on these contracts, it is again suggested that Congressional concurrence be requested for the discontinuance of future annual GAO review of these contracts.

3. SPECIFIC COMMENTS

There is a statement in the report that Electric Boat believes is not germane to the clearly stated requirement and purpose of the GAO report and should be deleted.

Page 4, paragraph 2 of the draft report states "During our review we learned that a federal grand jury, in September 1983, indicted former General Dynamics' officials for

GENERAL DYNAMICS
Electric Boat Division

January 30, 1984
Page 2

receiving kickbacks in connection with subcontracts on shipbuilding projects at the Quincy and Electric Boat shipyards. The SSN688 class submarine program is involved in the alleged kickback scheme. The relationship of this development to the use of Public Law 85-804 settlement funds cannot be determined at this time."

Based upon this Division's loss situation on the two contracts, the alleged kickback scheme could have no possible impact on the use of Public Law 85-804 settlement funds. Thus, paragraph 2 of page 4 should be deleted.

4. The Division requests that you make the above noted deletion to your report and that a copy of this letter be included with your final report submitted to the Congress.



A. M. Barton
Division Vice President -
Finance and Strategic Planning



OFFICE OF THE UNDER SECRETARY OF DEFENSE

WASHINGTON D C 20301

RESEARCH AND
ENGINEERING

10 FEB 1984

(AM) Frank C. Conahan, Director
National Security and
International Affairs Division
U. S. General Accounting Office
441 G. St. N.W.
Washington, D.C. 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report "The 1978 Navy Shipbuilding Claim Settlement At Electric Boat--Status As Of July 2, 1983," dated January 10, 1984 (GAO Code No. 942265; OSD Case No. 6434).

In essence, GAO concludes that (1) the authorized funds were used only in the specified contracts, (2) the contractor did not realize any total combined profit on the contracts (as stipulated in Section 821 of Public Law 95-485), (3) construction costs have overrun the contract ceiling and the contractor is now bearing the entire cost of any overrun to complete deliveries, and (4) a federal grand jury, in September 1983, indicted former General Dynamic's officials for receiving kickbacks on shipbuilding projects, including the SSN-688 class submarine program, at the Quincy and Electric Boat Shipyards.

The DoD has reviewed the report and agrees with the facts and conclusions. For completeness, however, your staff has agreed that in finalizing the report, several changes should be made to the second paragraph on page 4 of the draft report as follows:

"During our review we learned that a Federal Grand Jury, in September 1983, indicted former General Dynamics' officials for receiving kickbacks from a subcontractor in connection with shipbuilding contracts at the Quincy and Electric Boat Shipyards. The bulk of the allegations involve kickbacks on subcontracts on liquid natural gas tankers being built at Quincy, but there are allegations that subcontracts under SSN 688 Class Submarine contracts may also have been involved. The Navy is conducting an investigation to determine what effect, if any, there was on the submarine contracts. The possible relationship between the kickbacks and Public Law 85-804 settlement funds cannot be determined at this time."

Since your staff has agreed to incorporate these changes in the final report for completeness, and the facts and conclusions in the draft report are accurate, further DoD comments are unnecessary.

The DoD appreciates the professional manner in which the GAO has conducted the annual reviews of the Electric Boat Shipbuilding claims settlement.

Sincerely,



MARY ANN GILLECE
DEPUTY UNDER SECRETARY
(ACQUISITION MANAGEMENT)

cc: SEC NAVY

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